Volume 29 | Issue 1 Article 8

1984

# Taxation - Rental Deduction Standard Eased for Gift-Leaseback Transaction

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## TAXATION—RENTAL DEDUCTION STANDARD EASED FOR GIFT-LEASEBACK TRANSACTION

*Rosenfeld v. Commissioner* (2d Cir. 1983)

On July 1, 1969, Dr. George B. Rosenfeld,[1] as grantor, transferred the beneficial ownership of certain real property to a ten and one-half year irrevocable Clifford trust.[2] Rosenfeld retained a reversionary interest in the corpus of the trust in which his three daughters were named as beneficiaries, and his accountant and lawyer were designated as co-trustees.[3] Contemporaneous with the creation of the trust, Rosenfeld entered into a lease agreement with the trustees to rent the trust property.[4] Pursuant to the terms of the lease,[5] Rosenfeld was required to pay $14,000 per year to the trust, an amount determined to be the fair rental value of the property.[6] In 1973, Rosenfeld transferred to his wife his reversionary interest in the corpus of the trust.[7] In 1975, Rosenfeld and the trustees modified the agreement by extending the termination date of the trust for five years, increasing the annual rental by $1,000, and extending the rental term for one year with a one-year option.[8] In his returns for the taxable years 1974 and 1975, George Rosen-

1. Rosenfeld v. Commissioner, 706 F.2d 1277 (2d Cir. 1983). George B. Rosenfeld, a medical doctor, was the taxpayer in this action. *Id.* at 1278. Harriet Rosenfeld was also a party to this action because she filed a joint tax return with her husband. *Id.* n.1. For purposes of clarity, Dr. and Mrs. Rosenfeld will be referred to as "Rosenfeld."

2. *Id.* at 1278-79. The real property which is the corpus of the Rosenfeld Clifford trust is located in Cheektowaga, New York. *Id.* at 1278. It was purchased by George Rosenfeld in 1963. *Id.* Shortly thereafter, arrangements were made to construct a building on the property which was to be used as a medical office. *Id.* Rosenfeld has been the sole occupant of the building since its completion in 1964. *Id.* For a discussion of the requirements and purpose of a Clifford trust, see notes 21-24 and accompanying text *infra*.

3. 706 F.2d at 1279. The termination date of the trust was set for 1980. *Id.* The terms of the Clifford trust required Rosenfeld to remain liable for the mortgage payments and the general upkeep of the property. *Id.* The trust provisions held the trustees responsible for the payment of real estate taxes. *Id.* Rosenfeld has no unilateral right to alter the terms of the trust. *Id.* For a discussion of Clifford trusts, see note 24 and accompanying text *infra*.

4. 706 F.2d at 1279. For a discussion of leaseback agreements in the context of a Clifford trust, see note 24 and accompanying text *infra*.

5. 706 F.2d at 1279. The lease was to run for the entire term of the trust. *Id.* The terms of the lease required Rosenfeld to pay for utilities and other incidental expenses. *Id.* It also granted Rosenfeld the right to construct additions to the property at his own expense. *Id.*

6. *Id.* Prior to executing the transaction, Rosenfeld arranged for an independent appraiser to value the property. *Id.* The fair rental value was calculated based on the use of all three floors of the building as office space. *Id.* at 1284 (MacMahon, J., dissenting). However, Rosenfeld used the third floor for storage only. *Id.*

7. *Id.* at 1279.

8. *Id.* The modification of the trust to extend its termination date and the modi-

feld deducted the $14,000 paid under the lease agreement as a business expense pursuant to section 162(a)(3) of the Internal Revenue Code (Code).[9]

After an audit, the Commissioner of the Internal Revenue Service (Commissioner) disallowed Rosenfeld's rental deductions, claiming that such payments were not ordinary and necessary business expenses within the meaning of section 162(a)(3).[10] The Tax Court disagreed with the Commissioner, holding that the rental payments were proper deductions.[11] The United States Court of Appeals for the Second Circuit[12] affirmed, *holding* that a deduction for rental expenses pursuant to section 162(a)(3) of the Code is proper where the economic and beneficial rights of a taxpayer are substantially altered by a gift-leaseback transaction which was otherwise proper under the Clifford sections of the Code. *Rosenfeld v. Commissioner*, 706 F.2d 1277 (2d Cir. 1983).

Section 162(a) of the Code permits a taxpayer to deduct from his personal income[13] those ordinary and necessary expenses paid or incurred in

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fication of the lease agreement to reduce the rental term had the effect of extending the life of the trust beyond that of the lease. *Id.* Rosenfeld also held a one-year option to renew the terms of the rental agreement. *Id.*

9. Rosenfeld v. Commissioner, 43 T.C.M. (CCH) 1353, 1355 (1982), *aff'd*, 706 F.2d 1277 (2d Cir. 1983). For the text of section 162(a)(3) of the Code, see note 14 and accompanying text *infra*. In 1974, rental payments were made by check directly to the trustees. 43 T.C.M. at 1355. In 1975, such rental payments were made through Rosenfeld's payment of $2442.00 in real estate taxes, through his transfer to the trust of $11,158.87 of securities, and through a cash payment of $399.13. *Id.* However, the manner in which payment was made was not an issue on appeal. 706 F.2d at 1279. For the same period, the trust filed fiduciary tax returns and reported the amount of rent paid by Rosenfeld as income. *Id.* On its fiduciary returns for 1975, the trust also claimed deductions for real estate taxes and depreciation on the building. *Id.*

10. 43 T.C.M. (CCH) at 1355. Following the Internal Revenue Service audit, Rosenfeld received a statutory notice of deficiency. 706 F.2d at 1279. In disallowing the deduction, the Commissioner took the position that a gift-leaseback is a single transaction, and unless there exists a valid business purpose for the entire arrangement, the transaction should not be recognized. 43 T.C.M. (CCH) at 1356. In lieu of the rental deduction, the Commissioner was willing to allow Rosenfeld to deduct the taxes and depreciation attributable to the property. *Id.* at 1355. Rosenfeld challenged the Commissioner's assessment. 706 F.2d at 1279.

11. 43 T.C.M. (CCH) at 1353. In allowing the rental deductions, the Tax Court found that the rent paid was reasonable, that a bona fide business purpose existed for the leaseback, that Rosenfeld did not possess a disqualifying equity interest in the property, and that his control over the property was not substantially the same as that which existed before the gift was made. *Id.* at 1357. As a result, the deficiencies for the years 1974 and 1975 were recalculated and Rosenfeld was held liable only for non-rental deduction deficiencies. 706 F.2d at 1279.

12. The case was heard by Judges Kaufman and Kearse and Judge MacMahon of the United States District Court for the Southern District of New York, sitting by designation. Judge Kaufman wrote the majority opinion and Judge MacMahon dissented.

13. I.R.C. § 162(a) (1982). These deductions are not direct deductions against the taxpayer's gross income, but may be applied only against income received by the taxpayer in operating a trade or business as a sole proprietorship. Thus, the net income from the trade or business is reported on the personal return as "income

carrying on a trade or business.[14] To be deductible under this section, an expense must meet the following requirements: 1) it must be paid or incurred during the year in connection with a trade or business;[15] 2) it must be a business rather than a personal expense;[16] 3) it must be a current expense, not a capital outlay;[17] and 4) it must be ordinary and necessary.[18]

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received from a trade or business." For the text of section 162(a)(3) of the Code, see note 14 *infra*.

14. 706 F.2d at 1279. Section 162(a) provides in pertinent part as follows:

> There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business including
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> . . . (3) Rental and other payments required to be made as a condition to the continued use or possession for purposes of trade or business, of property to which the taxpayer has not taken or is not taking title in which he has no equity.

I.R.C. § 162(a)(3) (1982).

15. Although the Code has never defined "trade or business," different tests have been developed by the different circuits to determine whether a trade or business exists. However, the Supreme Court, in addressing this issue, stated, "To determine whether the activities of a taxpayer are 'carrying on a business' requires an examination of the facts in each case. . . . The Bureau of Internal Revenue has this duty of determining what is carrying on a business, subject to reexamination of the facts by the Board of Tax Appeals and ultimately to review on the law by the courts in which jurisdiction is conferred." Higgins v. Commissioner, 312 U.S. 212, 217-18 (1941). This *ad hoc* determination has led to the exercise of different tests among the circuits as to what constitutes carrying on a trade or business. For example, the Third Circuit looked to the dictionary, and concluded that "business" meant "that which busies or engages time, attention or labor as a principal serious concern or interest; any particular occupation . . . for livelihood or gain." DuPont v. Deputy, 103 F.2d 257 (3d Cir. 1939), *rev'd on other grounds*, 308 U.S. 488 (1940). The Sixth Circuit has defined "business" to be a very comprehensive term, embracing everything about which a person could be employed, and as that which occupies time, attention, and labor for the purpose of livelihood or profit. Kales v. Commissioner, 101 F.2d 35 (6th Cir. 1937). Finally, the Second Circuit has held: "By the common speech of men, a person who does nothing beyond looking after his own investments and receiving the income from them is not conducting a trade or business." *Higgins*, 111 F.2d at 796-97.

16. *See* I.R.C. § 162 (1982). *See also* I.R.C. § 262 (1982) (providing that no deduction shall be allowed for personal, living, or family expenses). The requirement that the expense be business, as opposed to personal in nature, requires a direct and proximate relationship between the business and the purpose of the expenditure. Freedman v. Commissioner, 301 F.2d 359 (5th Cir. 1962) (costs incurred in settling a lawsuit against taxpayer for personal injuries resulting from an auto accident while driving between two jobs not proximately connected to either job and thus not deductible). *Cf.* Kornhauser v. United States, 276 U.S. 145 (1928) (allowing expenses incurred in defending an action brought by a former business partner to be deducted as trade and business expenses).

17. I.R.C. § 162(a) (1982). *See also* I.R.C. § 263 (1982) (no deduction shall be allowed for payments which increase the value of any property).

18. Welch v. Helvering, 290 U.S. 111 (1933). The terms "ordinary and necessary" have been defined by the courts as those expenses which need not "be habitual or normal in the sense that the same taxpayer will have to make them often," but those which "because we know from experience that payments for such a purpose, . . . are the common and accepted means of defense against attack." *Id.* at 114. *Welch* involved a taxpayer who was in business as a commission agent for a corpora-

Embraced within the ambit of section 162(a) are rental payments incurred as a necessary cost of carrying on a taxpayer's business.[19] To take advantage of this provision, taxpayers frequently entered into gift-leaseback agreements,[20] transactions in which a taxpayer makes a gift of property to another, and subsequently leases the property back to himself. As a result, the taxpayer becomes obligated to pay rent on property which he previously owned. The taxpayer then deducts these rental payments under section 162(a)(3), thereby reducing his taxable income.[21] The recipient and subsequently, the lessor of the property, in a gift-leaseback arrangement is often a trust.[22]

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tion that had gone into bankruptcy. *Id.* After the company had been adjudged bankrupt and its debts had been discharged, the taxpayer paid creditors of the bankrupt corporation in an attempt to fortify his individual standing and credit. *Id.* at 112. The taxpayer then deducted these payments on his personal income tax returns as ordinary and necessary expenses incurred in his business. *Id.* at 113. The Supreme Court disallowed the deduction, noting that "[m]en do at times pay the debts of others without legal obligation, . . . but they do not do so ordinarily." *Id.* at 114.

Ordinary expenses have been held to include expenses incurred in the defense of a criminal charge growing out of the business of the taxpayer, and payments of debts discharged in bankruptcy, but subject to being revived by force of a new promise. Commissioner v. People's-Pittsburgh Trust Co., 60 F.2d 187 (1932). *See also* Midland Empire Packing Co., 15 T.C. 635 (1950). The term "carrying on" a trade or business has been defined to allow as a deduction expenses incurred if the taxpayer is already engaged in a trade or business. Morton Frank v. Commissioner, 20 T.C. 511 (1953). In *Morton Frank*, the Tax Court disallowed expenses incurred by taxpayers in search of business, stating, "[E]xpenses of investigating and looking for a new business . . . are not deductible as an ordinary and necessary business expense incurred in carrying on a trade or business." *Id.* at 513. *See also* Colorado Springs Nat'l Bank v. United States, 505 F.2d 1185 (10th Cir. 1974).

19. I.R.C. § 162(a)(3) (1982).

20. For a detailed discussion of taxpayers' efforts to reduce income through the execution of gift-leaseback arrangements, see Comment, *Gift-Leaseback Transactions: An Unpredictable Tax-Savings Tool*, 53 TEMP. L.Q. 569 (1980).

21. For a detailed discussion of the effect of a gift-leaseback arrangement on tax minimization, see Froehlich, *Clifford Trusts: Use of Partnership Interests as Corpus; Leaseback Arrangements*, 52 CALIF. L. REV. 956 (1964). This author suggests that because this transaction attempts to reduce family taxes by income-splitting, failure of the plan merely relegates the taxpayer to the same position which he occupied before the leaseback arrangement. *Id.* The author argues that if the deduction is denied, the rental payments will be viewed as a gift to the trust. This gift will presumably not constitute income. *Id.* at 976-77. Consequently, the author contends that the Clifford trust leaseback plan falls into the category of "what do you have to lose?" *Id.* As noted by the author, however, the test for income realization from the alleged gift to the trust is not related to the test for deductibility of rent to the taxpayer. *Id.* For a discussion of the Clifford rules as a standard for determining income realization, see Cohen, *Transfers and Leasebacks to Trusts: Tax and Planning Considerations*, 43 VA. L. REV. 31, 41 (1957). *See also* Note, *Gifts and Leasebacks: Is Judicial Consensus Impossible?*, 49 U. CIN. L. REV. 379 (1980).

22. A trust is a "fiduciary relationship in which one person is the holder of the title to property subject to an equitable obligation to keep or use the property for the benefit of another." G. BOGERT & G. BOGERT, LAW OF TRUSTS 1 (5th ed. 1973) (footnote omitted). The settlor of a trust "is the person who intentionally causes the trust to come into existence." *Id.* The trustee "is the person who holds title for the benefit of another." *Id.* The trust property "is the property interest which the trustee

The most common type of gift-leaseback agreement involves the transfer of real property by the taxpayer to a Clifford trust,[23] an irrevocable trust that must exist for a minimum ten-year period, and which allows the income derived from the property to be taxed to the trust.[24] The Internal Revenue Service (Service) has not looked favorably upon taxpayers' efforts to claim a business deduction for rental payments made to a family trust under a gift-leaseback arrangement.[25] Taxpayers have argued that these deductions should be allowed if the Clifford trust has been executed according to the Clifford provisions of the Code.[26] In response, the Commissioner has argued that the United States Treasury Regulations indicate that the Clifford trust requirements are not to be used by the Service to determine whether a taxpayer may deduct rental payments to a trust pursuant to a gift-leaseback arrangement.[27] Rather, the Commissioner has argued, the Clifford trust re-

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holds subject to the rights of another." *Id.* The beneficiary "is the person for whose benefit the trust property is to be held by the trustee." *Id.* at 2. The trust instrument "is the document by which property interests are vested in the trustee and beneficiary and the rights and duties of the parties (called the trust terms) are set forth." *Id. See also* Keplinger v. Keplinger, 185 Ind. 81, 85, 113 N.E. 292, 293 (1916).

23. The Clifford trust was judicially created. *See* Helvering v. Clifford, 309 U.S. 331 (1940). In *Clifford*, a husband-taxpayer declared himself the trustee of certain securities for the benefit of his wife for a period of five years. *Id.* at 332. The taxpayer retained complete control over the principal fund. *Id.* at 332-33. The income from the trust was to be distributed to the taxpayer's wife. *Id.* at 332. Subsequently, the taxpayer attempted to reduce his tax liability by claiming that the income should be taxed to the beneficiary and not to him. *Id.* at 333-34. The Supreme Court disagreed, holding that the execution of the trust had not changed the taxpayer's position. *Id.* at 335. The Court stated, "When the benefits flowing to him indirectly through the wife are added to the legal rights he retained, the aggregate may be said to be a fair equivalent of what he previously had." *Id.* at 336.

24. In direct response to the *Clifford* decision, the Treasury Department promulgated the Clifford regulations. These regulations were incorporated into the 1954 Code. *See* I.R.C. §§ 671-678 (1982). The Clifford provisions require that in order for income to be taxed to the beneficiary rather than the grantor, the trust must be irrevocable; any reversionary interest retained by the grantor may not take effect within 10 years from the execution of the trust or before the death of the income beneficiary; the grantor may not retain any administrative powers; and the trust corpus may not be used or the income accumulated to the grantor or his spouse to discharge their obligations. *Id.* §§ 673, 675-677(a).

25. Comment, *supra* note 20, at 570-71. As a result of this hostility, the gift-leaseback has been designated a "prime issue" by the Internal Revenue Service. "Prime issues" are areas which are given close scrutiny by the IRS, and as a result, such cases are litigated rather than settled or conceded. Internal Revenue Service Manual, MT-1277-8 No. 0671.01-01 (Nov. 19, 1974). As a result, the amount of Clifford-related litigation has increased, while the number of settlements have decreased. *Id.* The inconsistent approaches employed by the courts in evaluating the legitimacy of these deductions have compounded the problem. Comment, *supra* note 20, at 570. *See also* Pratt & Bell, *Trust-Leaseback Arrangements: Where Do They Stand?*, 120 TR. & EST. 45 (Jan. 1981).

26. *See, e.g.*, Froehlich, *supra* note 21, at 973-74; Note, *Clifford Trusts: A New View Towards Leaseback Deductions*, 43 ALB. L. REV. 585, 594-95 (1979). For a discussion of the effect of compliance with the Clifford provisions on leasebacks, see Note, *supra* note 21, at 393-94.

27. *See* S. REP. NO. 1622, 83d Cong., 2d Sess., *reprinted in* 1954 U.S. CODE CONG.

quirements are to be used to determine whether the income from the trust should be taxed to the trust or the grantor.[28] However, several courts have ignored the Service's admonition, employing Clifford-type considerations to determine whether a rental payment satisfies the provisions of section 162(a)(3).[29]

In 1973, these judicially-adopted Clifford-type considerations became embodied in a four-prong test in the case of *Mathews v. Commissioner*,[30] in which the Tax Court endeavored to evaluate the legitimacy of rental deductions taken following a gift-leaseback arrangement. The Tax Court stated that in order for such rental payments to be deductible, the gift-leaseback transaction most meet the following requirements: 1) the grantor must not have retained substantially the same control over the property that he had before he made the gift; 2) the leaseback agreement should be in writing; 3) the leaseback (as distinguished from the gift) must have a bona fide busi-

& AD. NEWS 4621, 5006; 26 C.F.R. § 1.671-1(c) (1982) (these sections have "no application in determining the right of a grantor to deductions for payments to a trust under a transfer and leaseback arrangement"). *See also* Perry v. United States, 520 F.2d 235, 238 (4th Cir. 1975) (although a Clifford trust had been validly executed, there was no business purpose for this execution and therefore, no deduction was allowed), *cert. denied*, 423 U.S. 1052 (1976).

28. Compliance thus enables the grantor to shift income to the trust beneficiaries, who will be taxed at lower rates than the grantor.

29. *See* Quinlivan v. Commissioner, 599 F.2d 269 (8th Cir.), *cert. denied*, 444 U.S. 996 (1979); Brown v. Commissioner, 180 F.2d 926 (3d Cir.), *cert. denied*, 340 U.S. 814 (1950). These considerations generally track the analysis used by the Court in *Clifford*. Although the courts have analyzed compliance with §§ 671-678 of the Code, they have scrutinized the grantor's dominion and control on a much stricter level. For example, the Clifford provisions of the Code allow a taxpayer to appoint himself, or other members of his family as trustee. I.R.C. §§ 671-678 (1982). Courts, however, have disallowed a rental deduction for Clifford trusts where the taxpayer or a member of his family serves as trustee. *See* Van Zandt v. Commissioner, 341 F.2d 440 (5th Cir.), *cert. denied*, 382 U.S. 814 (1965) (rental deduction disallowed where taxpayer-grantor named himself as trustee because trustee lacked the requisite independence). Retention of the reversionary interest is also allowed under the Clifford provisions, yet has led the Tax Court to disallow the deduction. *See* Armston v. Commissioner, 12 T.C. 539 (1949), *aff'd*, 188 F.2d 531 (5th Cir. 1951); Brown v. Commissioner, 12 T.C. 1095 (1949), *rev'd*, 180 F.2d 926 (3d Cir.), *cert. denied*, 340 U.S. 814 (1950); Skemp v. Commissioner, 8 T.C. 415 (1947), *rev'd*, 168 F.2d 598 (7th Cir. 1948). For a discussion of courts' attempts to employ Clifford-type considerations in determining whether rental payments satisfy section 162(a), see Comment, *supra* note 20, at 570.

30. 61 T.C. 12 (1973), *rev'd*, 520 F.2d 323 (5th Cir. 1975), *cert. denied*, 424 U.S. 967 (1976). In *Mathews*, the Tax Court consolidated requirements which it had announced in prior decisions. 61 T.C. at 18-19. *See* Penn v. Commissioner, 51 T.C. 144, 150 (1968); Oakes v. Commissioner, 44 T.C. 524 (1965); Van Zandt v. Commissioner, 40 T.C. 824, *aff'd*, 341 F.2d 440 (5th Cir.), *cert. denied*, 382 U.S. 814 (1965). For example, the first prong, control, found its basis in *Van Zandt*. 40 T.C. at 831. The second prong, the writing requirement, was first enunciated in *Penn*. 51 T.C. at 144. The valid business purpose prong was based upon the holding of *Oakes*. 44 T.C. at 524. The fourth requirement, however, found its basis within the language of section 162(a)(3) of the Code. I.R.C. § 162(a)(3) (1982). *See also* May v. Commissioner, 76 T.C. 713 (1981); Quinlivan v. Commissioner, 599 F.2d 269, 272 (8th Cir.), *cert. denied*, 444 U.S. 996 (1979).

ness purpose; and 4) the grantor may not possess a disqualifying "equity" in the property within the meaning of section 162(a)(3).[31]

In analyzing the first prong of the Tax Court test, courts have generally equated relinquishment of control by the grantor with independence of the trustee. Therefore, inquiry has focused on the degree of independence of the trustee.[32] The important factors which both the Tax Court and the courts of appeals have considered in determining whether the trustee is independent include the following: (1) the identity of the trustee; (2) the pre-arrangement of the leaseback; and (3) the powers retained by the grantor.[33]

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31. *Mathews*, 61 T.C. at 12. For a discussion of various courts' analyses of the first prong, see text accompanying notes 34-48 *infra*. For a discussion of the various courts' analyses of the second prong, see text accompanying notes 49-52 *infra*. For a discussion of the various courts' analyses under the third prong, see text accompanying notes 53-72 *infra*. For a discussion of various courts' analyses under the fourth prong, see text accompanying notes 73-86 *infra*.

32. 61 T.C. at 13. The inquiry into the independence of the trustee is grounded upon the belief that if a trustee is indeed independent, his fiduciary obligation will compel him to act in the best interests of the beneficiaries. Thus, the grantor will not be able to exert undue influence over the property, and will have thus relinquished control. Van Zandt v. Commissioner, 341 F.2d 440, 443 (5th Cir.), *cert. denied*, 382 U.S. 814 (1965). Where a grantor has appointed himself trustee, courts have consistently held that he lacked sufficient independence to allow a rental deduction. *See, e.g.*, Wiles v. Commissioner, 59 T.C. 289, *aff'd mem.*, 491 F.2d 1406 (5th Cir. 1974). The courts have reasoned that where the grantor has named himself as trustee, there is no independence because the principal amount of the trust is simply transferred from the grantor in his individual capacity to himself as trustee. *Van Zandt*, 341 F.2d at 443. *Cf.* Brooke v. United States, 468 F.2d 1155, 1158 (9th Cir. 1972) (where a grantor serves as trustee pursuant to a court appointment, the court has found the requisite independence and the business deduction has been allowed).

In analyzing trustee independence, some courts have examined the nature of the relationship between the grantor and the trustee. These cases assume retention of control by the grantor where because of a family or similar relationship there exists a strong possibility of grantor dominance over the trustee. *See* Furman v. Commissioner, 45 T.C. 360 (1966) (rental deduction denied where grantor's wife named as trustee). *See also* White v. Fitzpatrick, 193 F.2d 398 (2d Cir. 1951) (rental deduction denied where wife, as donee of business property, acquiesced in the husband-donor's management of the property), *cert. denied*, 343 U.S. 928 (1952); Chace v. United States, 303 F. Supp. 513 (M.D. Fla. 1969) (rental deduction denied where grantor's equitable interest in the trust property denied his wife and friend, as trustees, of independent management of the property), *aff'd per curiam*, 422 F.2d 292 (5th Cir. 1970). Other courts have scrutinized objective circumstances surrounding the transaction. These circumstances include not only the terms of the trust and lease agreements, but also the amount of rent paid and whether the lease was prearranged. *See* Mathews v. Commissioner, 61 T.C. 12, 18 (1973), *rev'd*, 520 F.2d 323 (5th Cir. 1975), *cert. denied*, 424 U.S. 967 (1976). For a more detailed discussion of the courts' varying approaches to this issue, see Note, *supra* note 26, at 393-94.

33. Comment, *supra* note 20, at 575-77. The courts have closely scrutinized trustee independence in the belief that granting control and ownership to an independent trustee is "strongly indicative of the bona fides of the transfer." Oakes v. Commissioner, 44 T.C. at 529 (1965). *See generally* Felix v. Commissioner, 21 T.C. 794 (1954). The Seventh Circuit has also allowed the deduction although the leaseback situation was voluntarily created by the taxpayer, in the belief that the independence of the trustee required him to exact rent and required the same payment by the taxpayer. Skemp v. Commissioner, 168 F.2d 598, 600 (7th Cir. 1948). For a

In analyzing the identity of the trustee, courts have scrutinized gift-leaseback transactions to determine whether there exists a relationship between the grantor and trustee which would allow the grantor to exert control over the property. Accordingly, the Tax Court has consistently found that a taxpayer-grantor lacks the requisite independence to serve as trustee.[34] The federal courts have also been unwilling to find the requisite trustee independence in the leaseback context where a familial relationship exists between the grantor and the trustee. For example, in *Chace v. United States*,[35] the Fifth Circuit held that where the grantor named his wife and brother-in-law as co-trustees, the business deduction should be disallowed because the close relationship between the trustee and grantor barred the trustee from being completely independent.[36] On the other hand, several other circuit courts of

further discussion of the effects of trustee independence on rental deductions, see Duffy v. United States, 343 F. Supp. 4 (S.D. Ohio 1972). *See also* Brown v. Commissioner, 180 F.2d 926 (3d Cir.), *cert. denied*, 340 U.S. 814 (1950).

34. *See, e.g.*, Van Zandt v. Commissioner, 40 T.C. 824 (1964)(where property was conveyed to the trustee, and the trustee was the original grantor, "the whole principal amount of the trust was irrevocably committed to the possession of the grantor the moment the trust was created"), *aff'd*, 341 F.2d 440 (5th Cir.), *cert. denied*, 382 U.S. 814 (1965); Penn v. Commissioner, 51 T.C. 144, 154 (1968) (where grantor named himself as trustee, there was no "complete divestiture by the grantor of his interest in the trust property to a new, 'independent' owner"). Although the Tax Court has disallowed the rental deduction where the grantor has named himself as trustee, the Treasury Regulations dealing with the requirements of a Clifford trust do not prohibit a grantor from appointing himself as trustee. Treas. Reg. § 1.671-1 T.D. 7741 (1980). This incongruity between the Tax Court and the Treasury Department may indirectly induce a taxpayer to name himself as trustee in the belief that his compliance with the Clifford provisions will allow a rental deduction. *See* note 29 and accompanying text *supra*.

35. 303 F. Supp. 513 (M.D. Fla. 1969), *aff'd per curiam*, 422 F.2d 292 (5th Cir. 1970). In *Chace*, the taxpayer-settlor executed a trust for 10 years and one day, naming his wife and brother-in-law as co-trustees and his children as beneficiaries. 303 F. Supp. at 513. The corpus of the trust consisted of an office building used by the settlor in his dentistry practice. *Id.* at 513-14. After executing the trust, the settlor entered into a lease agreement with the trustees for a three-year period. *Id.* at 514. The agreement contained an option clause which allowed the settlor-lessee to renew the lease for three additional periods of three years, with each period at the same rent as the original term. *Id.* The Commissioner disallowed the rental deduction on Dr. Chace's return, holding that the execution of the trust was a sham. *Id.* at 514-15. The district court agreed, quoting Judge Tuttle in *Van Zandt*: "[I]t seems clear that we do not have the normal relationship that exists when an 'independent' trust is created . . . ." *Id.* at 516 (quoting Van Zandt v. Commissioner, 341 F.2d 440, 443 (5th Cir.), *cert. denied*, 382 U.S. 814 (1965)).

36. *Id.* The Tax Court has, however, allowed the deduction where the familial trustee was a co-trustee with the grantor's accountant. Potter v. Commissioner, 27 T.C. 200 (1956). In *Potter*, the taxpayer created irrevocable trusts for his wife and minor children. *Id.* at 203. He then transferred to the trusts the right, title, and interest to a certain patent application. *Id.* At the time the trusts were executed, the trustees entered into a nonexclusive license agreement with the taxpayer whereby the taxpayer, in exchange for a royalty, could make, use, and sell the article under patent. *Id.* at 204. The taxpayer then deducted the royalty payments under § 23(a)(1)(A) of the 1939 Code (subsequently revised and presently codified at IRC § 162(a) (1982)). The Commissioner disallowed the deduction, arguing that the royalty payments were not ordinary and necessary. *Id.* at 213. The Tax Court disagreed

appeals have allowed the deduction where the grantor has appointed a trustee who was not a member of the grantor's family. In *Brown v. Commissioner*,[37] the Third Circuit allowed a deduction where the grantor's attorney was appointed as trustee.[38] Similarly, in *Quinlivan v. Commissioner*,[39] the Eighth Circuit found sufficient independence and therefore, allowed a deduction where a bank was appointed as trustee.[40]

The question of whether the leaseback agreement was arranged prior to the execution of the trust may play an important role in determining whether the trustee is independent. The Fourth and Seventh Circuits have examined this issue and have reached conflicting results. In *Perry v. United States*,[41] the terms of the leaseback, including the trustee's duties as lessor, were arranged prior to the execution of the trust. The Fourth Circuit disallowed the deduction since all the trustee's duties had been predetermined,

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and allowed the deduction. *Id.* at 216. In analyzing the independence of trustees, the Tax Court acknowledged the relationship between the trustees and the settlor, but concluded without elaborate inquiry that the trustees were independent. *Id.* at 213. *See also* May v. Commissioner, 76 T.C. 7 (1981) (rental deduction allowed where taxpayer was co-trustee with a friend who had served as trustee of other trusts).

37. 180 F.2d 926 (3d Cir.), *cert. denied*, 340 U.S. 814 (1950). In *Brown*, the taxpayers, husband and wife, were engaged as partners in the general contracting and coal mining business. *Id.* at 927. The taxpayers executed a trust whereby title to land which they used in business was transferred to a trustee with the understanding that the property was to be leased to the taxpayers. *Id.*

38. *Id.* at 929. In holding that the trustee possessed the requisite independence, the court observed that the controlling factor was the existence of a new independent owner, the trustee. *Id.* The *Brown* court based this holding on the fiduciary obligation of the trustee to exact the rental payments from the taxpayer as a condition to the continued use of the land. *Id.*

39. 599 F.2d 269 (8th Cir.), *cert. denied*, 444 U.S. 996 (1979). In *Quinlivan*, taxpayers were two attorneys engaged in a partnership in the practice of law. *Id.* at 271. In January 1964, each taxpayer executed irrevocable trusts for a period of 10 and one-half years. Each taxpayer transferred his one-half interest in the office building which they had owned as tenants in common. *Id.* A bank was named as trustee. *Id.* Shortly thereafter, the taxpayers and the trustee entered into a lease agreement to lease the property to the law firm. *Id.* The law firm deducted the rental payments made to the trustee. *Id.*

40. *Id.* at 272. In holding that the trustee was indeed independent, the Eighth Circuit relied on the fact that the law firm was obligated to pay rent under the written lease. *Id.* The court reasoned that, had these rental payments not been made by the law firm, the bank as trustee would have been under a fiduciary obligation to evict the law firm or sue the firm for the rent due. *Id. See also* Skemp v. Commissioner, 168 F.2d 598, 600 (7th Cir. 1948). For a further discussion of the analysis in *Quinlivan*, see Note, Quinlivan *Provides Gift-Leaseback Guidelines:* Quinlivan v. Commissioner, 26 ST. LOUIS U.L.J. 203 (1981).

41. 520 F.2d 235 (4th Cir.), *cert. denied*, 423 U.S. 1052 (1975). In *Perry*, the taxpayers were two physicians who had formed a medical partnership. *Id.* at 236. They acquired land as tenants in common, constructed an office on it, and used it for their medical practice. *Id.* Five years later, each taxpayer transferred his one-half interest in the property to a Clifford trust for the benefit of his children. *Id.* at 236-37. A bank was named as trustee. *Id.* at 237. Prior to the conveyance of the property to the trustee, a leaseback was arranged, and the trusts and leases were executed contemporaneously. *Id.*

and there were no powers in the trustee to manage the property.[42] However, in *Skemp v. Commissioner*,[43] the Seventh Circuit allowed the rental deduction, despite the fact that the leaseback had been prearranged.[44]

A final factor which has weighed heavily in courts' evaluation of the independence of the trustee is the scope of powers which the grantor retains over the trust property. For example, in *Hall v. United States*,[45] the grantor retained the right to settle accounts. The District Court for the Northern District of New York disallowed the deduction under these circumstances, citing a lack of trustee independence.[46] Similarly, in *Furman v. Commissioner*,[47] the grantor retained the power to prohibit the sale of the property.

42. *Id.* at 238. The taxpayers in *Perry* relied heavily upon a Seventh Circuit decision in which the court allowed a rental deduction despite the existence of a pre-arranged leaseback. *Id.* at 237 (citing Skemp v. Commissioner, 168 F.2d 598 (7th Cir. 1948)). The taxpayers attempted to distinguish *Skemp* from *Van Zandt v. Commissioner*, where the grantor named himself as trustee, claiming that the main distinction between the two cases was the existence of a corporate trustee. 529 F.2d at 237 (citing Van Zandt v. Commissioner, 341 F.2d 440 (5th Cir.), *cert. denied*, 382 U.S. 814 (1965)). However, the *Perry* court reasoned that the facts at bar were indistinguishable from those in *Van Zandt*, because in both cases the trustee had nothing to do with the management of the trust. *Id.* at 237-38. However, the Third Circuit, faced with a similar pre-arranged leaseback transaction, held just the opposite of *Perry*. *See* Brown v. Commissioner, 180 F.2d 926 (3d Cir.), *cert. denied*, 340 U.S. 814 (1950). In allowing the deduction, the court stated as follows: "It is true that this was done pursuant to a prior understanding between the taxpayers and the prospective trustee but we do not regard this point as significant." *Id.* at 929. For a further discussion of the Fourth Circuit's analysis in *Perry*, see Shurtz & Harmelink, *Trust-Leasebacks after* Quinlivan, 16 CAL. W.L. REV. 1, 7-8 (1980).

43. 168 F.2d 598 (7th Cir. 1948). In *Skemp*, the taxpayer, a physician, conducted his medical practice in a two-story office building which he owned. *Id.* at 599. The taxpayer created a trust for the benefit of his wife and children by conveying the property to the La Crosse Trust Company as sole trustee. *Id.* On the same day, the trustee and the taxpayer entered into a lease for a ten-year period. *Id.*

44. *Id.* at 600. In finding that the trustee was independent, the court relied on the fact that the trustee was bound by his fiduciary duty to exact rent from the taxpayer, and that the taxpayer was equally bound to pay the rent. *Id.* The court made no mention of the effect of the pre-arranged leaseback on the trustee's execution of his fiduciary obligations. *See also* Brown v. Commissioner, 180 F.2d 926 (3d Cir.) (deduction allowed: the existence of a new independent owner, the trustee, was the controlling factor, not the pre-arranged leaseback), *cert. denied*, 340 U.S. 814 (1950). For a discussion of the analysis used by the Seventh Circuit in *Skemp*, see Pratt & Bell, *supra* note 25, at 47.

45. 208 F. Supp. 584 (N.D.N.Y. 1962). In *Hall*, three doctors were engaged in a medical partnership. *Id.* at 585-86. Each doctor executed a trust, transferring his one-third interest in the property to the Tompkins County Trust Company, as trustee, for the benefit of his children. *Id.* at 586. Two days later, the trustee leased the property to the three doctors. *Id.* The grantors retained the power to ultimately dispose of the corpus of the trusts, and to settle the accounts of the trustee. *Id.*

46. *Id.* at 587. In discussing the grantor's reserved right to settle the accounts of the trustee, the court stated as follows: "[I]t is plain that by this device, the grantors retained an effective means of control over the actions of the trustee." *Id.* Therefore, the court concluded that a trustee cannot be wholly independent where the grantor had a reversionary interest and the right to settle accounts. *Id.* at 588.

47. 45 T.C. 360 (1966). In *Furman*, the taxpayer transferred property he owned to a Clifford trust for the benefit of his children. *Id.* at 361. Simultaneously, the

The Tax Court disallowed the deduction in the belief that the grantor's retention of these powers negatived any economic reality as to the existence of an independent trustee.[48]

The second prong of the Tax Court's test suggests that the lease should be in writing and that the payment of rent must be reasonable.[49] A written lease, though not an absolute prerequisite,[50] may be evidence of a legally binding relationship between the trustee and the grantor requiring the trustee to perform certain obligations for the benefit of the trust's beneficiaries.[51] The emphasis on a reasonable rent is based upon the notion that an arms-length transaction between the grantor and an independent trustee is the only guarantee of a reasonable rental agreement.[52]

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trustee and the grantor entered into a leaseback agreement. *Id.* The taxpayer, after giving the trustee broad powers to deal with the trust property, withdrew the trustee's power to sell the significant corpus of the trust without his permission. *Id.* at 364-65. Although the court noted that its decision was not premised on the grantor's retention of control, it did find that this control, coupled with other factors, made the entire transaction illusory. *Id.* at 366. The court reasoned that after the transaction the grantor was in the same economic position as he was before the execution of the trust. *Id.* Where the grantor's powers over the corpus are substantially the same after the execution of the trust as before it, the Tax Court has held the entire transaction to "lack economic reality." *See, e.g.*, Wiles v. Commissioner, 59 T.C. 289 (1972) (the informality of the rent arrangement was found to be indicative of the taxpayer's retention of control and thus the transaction lacked economic reality), *aff'd mem.*, 491 F.2d 1406 (5th Cir. 1974); Penn v. Commissioner, 51 T.C. 144 (1968) (grantor as sole trustee could sell, exchange, or rent the property, and therefore the economic reality was that the grantor retained control of the property).

48. *Furman*, 45 T.C. at 366.

49. *Mathews*, 61 T.C. at 18. For the other requirements of the four-prong test, see text accompanying note 31 *supra*.

50. One of the collateral requirements of the four-prong test is that the lease should normally be in writing. *See Mathews*, 61 T.C. at 18.

51. *Skemp*, 168 F.2d at 598. The *Skemp* court noted that the lease arrangement obligated the taxpayer to pay, and the trustee to collect, the rent. *Id.* at 600.

52. Audano v. United States, 428 F.2d 251, 257 (5th Cir. 1970). In *Audano*, a taxpayer acquired certain equipment in the course of his medical practice. *Id.* at 254. Subsequently, the taxpayer entered into a partnership with two other doctors. *Id.* The taxpayer then transferred title to this equipment to three trusts established for the benefit of his children. *Id.* The trustees then leased the property to the partnership. *Id.* at 255. No written lease existed. *Id.* During the five-year period, 1958-1962, the partnership paid approximately $58,000, or an average $11,700 annually, for use of the equipment. *Id.* at 257. However, the equipment cost the taxpayer no more than $15,000. *Id.* In 1961, the rental fee was changed to 5-10% of the partnership's gross receipts. *Id.* No evidence was offered as to the going rate for similar equipment. *Id.* Based on these facts, in disallowing the deduction, the *Audano* court found that the rent paid was unreasonable in relation to the transaction's stated purpose. *Id.* at 257. This finding was premised on the belief that the rental percentages were not determined as a result of arm's-length negotiations regarding the rental value of the equipment, but were instead established as a condition of taxpayer's continuation as the principal income-producing member of the partnership. *Id.* The *Audano* court held that because the taxpayer failed to rebut the presumption of unreasonable rent, the government was entitled to a judgment without submission of the issue to the jury. *Id.* It appears, therefore, that the existence of an arm's-length bargaining transaction negates the possibility of overlapping interests between the

The third element under the Tax Court's test requires that there be a valid business purpose for the gift-leaseback transaction.[53] However, courts are split as to what aspects of the transaction must meet this condition. One approach to this question, utilized by the Fifth Circuit in *Van Zandt v. Commissioner*,[54] may be referred to as the "single transaction business test."[55] In *Van Zandt*, the Fifth Circuit viewed the gift-leaseback arrangement as one integrated transaction, and consequently required that a valid business purpose exist for both the conveyance of the property to the trust and the subsequent leaseback.[56] Because the trust property was transferred from the taxpayer as an individual to himself as trustee,[57] the court reasoned that the original conveyance and leaseback must be viewed as one single transaction.[58]

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trustee and the grantor. At least one court has disallowed the deduction where the rental payments were varied and sporadic, thus lacking the indicia of an arm's-length bargaining transaction. *See* Wiles v. Commissioner, 59 T.C. 289 (1972), *aff'd mem.*, 491 F.2d 1406 (5th Cir. 1974). In *Wiles*, the court found that the informality of the rent arrangement was indicative of the fact that no formal relationship existed between the taxpayer and the trustee, and therefore the taxpayers had retained control over the property. *Id.* at 298.

53. *Mathews*, 61 T.C. at 13. For a discussion of the other requirements of the four-prong test, see text accompanying note 31 *supra*.

54. 341 F.2d 440 (5th Cir.), *cert. denied*, 382 U.S. 814 (1965).

55. *Cf.* Gregory v. Helvering, 293 U.S. 465 (1935). In *Gregory*, the taxpayer owned all the shares of the United Mortgage Corp., whose assets included shares of Monitor Securities Corp. It became possible to sell these Monitor shares at a large profit, but such a sale would have resulted in the imposition of a capital gains tax on United Mortgage, and another tax on the taxpayer when the profits were distributed to her in the form of dividends. *Id.* at 467. To reduce these taxes, the taxpayer incorporated a new company called the Averill Corp. *Id.* United Mortgage Corp. then transferred all of the Monitor Securities shares to Averill, and Averill transferred all of its shares to the taxpayer. *Id.* Three days later, the taxpayer wound up the Averill Corp., received the Monitor shares as the liquidating dividend, and then sold the shares. *Id.* In holding that no valid reorganization existed, the Supreme Court found that it was necessary to scrutinize the entire transaction in order to determine if what was done, apart from the tax motive, was within the ambit of the statute. *Id.* at 469.

56. 341 F.2d at 443. The Fifth Circuit rejected the bifurcated approach which had been utilized by the Tax Court and advocated by the taxpayer. *Id.* at 442. The Tax Court had declined to consider the business validity of the conveyance of the property to the trust, and focused solely on whether the rental payments were ordinary and necessary. *Id.* In adopting its integrated analysis, the Fifth Circuit noted that to adopt the Tax Court's approach would be to ratify schemes which should really be viewed as subterfuges for tax purposes. *Id.* (citing W.H. Armston Co. v. Commissioner, 188 F.2d 531 (5th Cir. 1951)).

57. In *Van Zandt*, taxpayer named himself as trustee of two irrevocable trusts, one for each of his children. *Id.* at 441. On the day he created the trusts, Dr. Van Zandt executed two lease agreements under which he leased back from the trustee the corpus of the trust, a medical building in which Dr. Van Zandt practiced. *Id.*

58. *Id.* at 443. After noting that the grantor and the trustee were one and the same, the court stated, "Thus, it seems to us inevitably we must look at the original conveyance of the property together with the execution of the leaseback as a single transaction." *Id.* However, it was not clear whether the court would have applied this test had the grantor not named himself as the trustee. The language of the opin-

Other circuits have viewed the transaction as bifurcated, distinguishing the gift from the leaseback.[59] These circuits only examine the leaseback to determine whether a valid business purpose exists.[60] This analysis has become known as the "necessity of expense test."[61] The first reported gift-leaseback case to apply the necessity of expense test was *Skemp v. Commissioner*.[62] In *Skemp*, a doctor transferred his ownership of a medical building to a trust in which his children were named as beneficiaries.[63] On the day the trust was created, the taxpayer entered into an agreement to lease the

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ion suggests that because the grantor retained complete control over the corpus at the time the trust was executed, a closer analysis into the original gift was required. *See id.* at 443. However, in discussing the *Van Zandt* decision, the Fifth Circuit stated,

> The outcome would not have differed had there been an outside independent trustee. We think *Van Zandt* teaches that it is not sufficient merely to serve up some 'business purpose' as some of the cases put it. The fact taxpayers can conjure up some reason why a businessman would enter into this sort of arrangement—tax consequences aside—does not foreclose inquiry. Rather there must be "economic reality."

*Mathews*, 520 F.2d at 325 (citations omitted).

59. *See Quinlivan*, 599 F.2d at 269; Brown v. Commissioner, 180 F.2d 926 (3d Cir.), *cert. denied*, 340 U.S. 814 (1950); *Skemp*, 168 F.2d at 598.

60. *See, e.g.*, *Quinlivan*, 599 F.2d at 269. In *Quinlivan*, the Eighth Circuit recognized that the overall transaction need not be considered. *Id.* at 273. The *Quinlivan* court stated as follows: "[T]he Congress has specified that the business purpose test is concerned with the 'continued use or possession' of the property. There is no justification for adding an inquiry into the origin of the lessor's title in applying this requirement." *Id.* The necessity of expense test has also been applied by the Third Circuit. Brown v. Commissioner, 180 F.2d 926 (3d Cir.), *cert. denied*, 340 U.S. 814 (1950). In *Brown*, the Commissioner argued that the gift of the property was indicative of the taxpayer's voluntary creation of an obligation to pay rent. *Id.* at 929. However, the court held that the only question to be decided was the deduction of rental payments from gross income, and that the gift of the property was irrelevant to that determination. *Id. See also Skemp*, 168 F.2d at 598 (gift of property found to be irrelevant in determining the deductibility of rental payments made to a trust).

61. *Skemp*, 168 F.2d at 598. Where the single transaction business purpose test is applied, the taxpayer generally has the burden of proving the existence of a valid business purpose for the initial gift. Taxpayers have encountered many difficulties in attempting to justify their gifts on acceptable business grounds because there is rarely a good business reason for making a gift of property. *See* Audano v. United States, 428 F.2d 251, 257 (5th Cir. 1970). For example, in *Mathews*, the taxpayers attempted to justify the initial gift by claiming that (1) they wanted to isolate the property from liability, and (2) they wanted to discourage employees from aspiring to partnership. *Mathews*, 520 F.2d at 325 n.7. Both arguments were rejected by the court on the grounds that creditors could probably attach the taxpayer's reversionary interest, and further, that employees might covet the profits of the business regardless of the ownership of property. *Id.*

62. 168 F.2d at 598.

63. In *Skemp*, the taxpayer was a practicing physician, who owned a two-story office building. *Id.* at 599. Part of the building was used for the taxpayer's medical practice, while the other part was rented to other persons for general office purposes. *Id.* The trust which was created by the taxpayer was irrevocable and of 20-years' duration, unless the settlor and his wife were to both die, whereupon the trust would terminate. *Id.* Upon termination of the trust, the property was to be distributed to the settlor's children. *Id.* The taxpayer retained no significant control over the trust, but did reserve the right to rent all or part of the building. *Id.*

medical building from the trustee.[64] The Seventh Circuit allowed the taxpayer's deduction of the rental payments under the lease, basing its holding on the fact that the legal obligation to pay rent had changed the taxpayer's position sufficiently to imbue a valid business purpose for the execution of the lease.[65] In *Brown v. Commissioner*,[66] the Third Circuit followed the reasoning of *Skemp*, allowing the rental deduction in a gift-leaseback transaction which closely resembled that presented in *Skemp*.[67] The Eighth Circuit has recently applied the necessity of expense test in *Quinlivan v. Commissioner*.[68] In holding that a business purpose need not be evidenced for the gift, the court held that the rental payments were a result of the legally binding relationship between the taxpayer and an independent trustee, and therefore, there was no justification for inquiring into the origin of the lessor's title.[69]

This same rationale was also applied by the Tax Court in *Oakes v. Commissioner*,[70] in which a taxpayer first transferred business property to an irrevocable trust over which he retained no control and subsequently leased the property back.[71] In permitting the taxpayer to take the deduction, the Tax Court held that it was not necessary to show the existence of a valid business purpose for making the gift.[72]

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64. *Id.* at 599. The lease granted the entire premises to the taxpayer for a 10-year period. *Id.* The rent for the first two years was fixed at $500 per month; thereafter, if a disagreement arose between the taxpayer and trustee, the rent would be set by a specified arbiter. *Id.* The $500 rent was not alleged to be unreasonable by the Commissioner. *Id.*

65. *Id.* at 600. The *Skemp* court stated,

> There can be no question but what rent required to be paid is properly deductible. The trustee was duty bound to exact rent of the taxpayer and the taxpayer was legally bound to pay it, just as much as if the taxpayer had moved across the street into the property of a third party.

*Id.* In looking only to the record for a valid business purpose, the court rejected the government's contention that because the transaction was voluntarily entered, it had no valid business purpose. *Id.* at 599-600.

66. 180 F.2d 926 (3d Cir.), *cert. denied*, 340 U.S. 814 (1950). For a discussion of the facts in *Brown*, see notes 37-38 and accompanying text *supra*.

67. 180 F.2d at 929-30. The court based its holding on the existence of a new independent owner, the trustee, and the obligation of the trustee to require the payment of rent and royalties as a condition of the taxpayer's continued use of the land. *Id.* at 929. Although *Brown* and *Skemp* were both decided before the four-prong test was formulated by the *Mathews* court, similar criteria were used.

68. 599 F.2d at 269. For a discussion of the facts in *Quinlivan*, see note 39 and accompanying text *supra*.

69. 599 F.2d at 273. The court also noted that the two leading cases, *Brown* and *Skemp*, were both decided in favor of the taxpayers before Congress rewrote the 1954 version of the Code. *Id.* at 274. In finding that the taxpayers in the present case were entitled to the deduction, the court stated, "Since Congress was rewriting the entire Code and made no pertinent change in the section dealing with business deductions, we can only conclude that it approved the result in *Brown* and *Skemp*." *Id.* at 274. For a discussion of *Brown*, see note 60 and accompanying text *supra*. For a discussion of *Skemp*, see text accompanying notes 60-65 *supra*.

70. 44 T.C. 524 (1965).

71. *Id.* at 526-27.

72. *Id.* at 532. The court recognized that a taxpayer may arrange his affairs so

The fourth and final prong of the Tax Court test requires that the taxpayer not possess a disqualifying "equity" interest in the trust property within the meaning of section 162(a)(3) of the Code.[73] However, neither Congress nor the Treasury Department has defined the parameters of the term within this section,[74] and therefore, courts have been in disagreement as to what constitutes "equity" within the meaning of the Code.

In determining the meaning of equity as applied to the gift-leaseback situation, the major issue has been whether reversionary interests constitute an equitable interest in the trust property.[75] The Tax Court, in *Mathews v. Commissioner*,[76] held that a reversionary interest in the trust is not equity within the meaning of section 162(a)(3) because such an interest is not derived from the lease agreement which is the concern of section 162(a)(3).[77]

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as to minimize his tax liabilities by means which the law permits. *Id.* It then stated that "[i]rrespective of what we said regarding business purpose in our *Van Zandt* opinion, we think that where . . . a grantor gives business property to a valid irrevocable trust over which he retains no control and then leases it back, it is not necessary for us to inquire as to whether there was a business reason for making the gift." *Id.* Consequently, the Tax Court has examined only the business propriety of the leaseback. *See, e.g.*, Richard A. Serbousek, 36 T.C.M. (CCH) 479 (1977). In this case, Serbousek and his partner transferred a medical building to a 10-year, 10-day irrevocable trust for the benefit of their children, naming a bank as trustee. *Id.* at 480. The medical partnership which was composed of the taxpayers, leased back the property for use in the medical practice. *Id.* The Tax Court noted that the lease was not prearranged, nor was a reversionary interest retained by the taxpayers. *Id.* at 482-83. The Tax Court noted that a valid business purpose was required only for the leaseback. However, the Tax Court stated that even if it had inquired into the purpose of the gift, the taxpayers had nonetheless established a valid business purpose. *Id.* at 483. The court viewed as reasonable the taxpayers' concern for the potential for conflicts which might result from their joint ownership of the land and building in the event that the partnership dissolved. *Id.*

73. *Mathews*, 61 T.C. at 19-20. *See also Quinlivan*, 599 F.2d at 270. For the text of § 162(a)(3), see note 14 *supra*.

74. *See* I.R.C. § 162(a)(3) (1982). *See also* Treas. Reg. § 1.162-11, T.D. 6291 (1958).

75. *See, e.g.*, Perry v. United States, 520 F.2d 235 (4th Cir.) (reversionary interests constitute a prohibited equity), *cert. denied*, 423 U.S. 1052 (1975); *Mathews*, 61 T.C. at 12 (reversionary interests not derived from the lease itself do not constitute equity within the meaning of § 162(a)(3)).

76. 61 T.C. at 12. In *Mathews*, a husband and wife created several irrevocable ten-year and one-day trusts for the benefit of their minor children. *Id.* at 14. In executing these trusts, the taxpayers transferred to their attorney as trustee, four equal undivided interests in property upon which the taxpayers operated a funeral home. *Id.* Upon the termination of the trust, the corpus was to be distributed to the grantors or their estates. *Id.* During the term of the trust, the net income was to be distributed currently to the beneficiary. *Id.* On or about the day the trust was executed, the trustee leased the property to the grantor, who continued to operate the property as a funeral home. *Id.* The lease agreement was prearranged. *Id.* Two years later, the trustee and the taxpayer entered into a new one-year lease for $14,040. *Id.* This sum was calculated to result in a profit for the trusts after all expenses had been taken into account. *Id.* Subsequently, the taxpayers transferred their reversionary interests in the funeral home property to a new irrevocable trust for the benefit of their four children. *Id.* at 14-15.

77. *Id.* at 23. The Tax Court concluded that the tax results would be unfair if a

In contrast, the Fourth[78] and Fifth[79] Circuits have held that where any type of reversionary interest in the corpus is retained by the grantor, the rental deduction should be precluded.[80] Thus, the source of the grantor's reversionary interest has divided courts in determining whether a reversionary interest constitutes an equitable interest.[81]

Where the taxpayer has transferred his reversionary interest to another, the courts have also reached inconsistent results. For example, in *Oakes v. Commissioner*,[82] the Tax Court allowed a rental deduction where the grantor had conveyed his reversionary interest to his wife, on the ground that even if the reversionary interest constituted a prohibited equity, the taxpayer had no such equity in the property at the time the returns were filed.[83] However,

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reversionary interest were held to constitute "equity," a result which Congress could not have intended. *Id.* at 22-23. In allowing this deduction, the *Mathews* court noted that if a reversionary interest retained by a grantor were held to constitute a prohibited equity, an owner of a reversion to become possessory after a 99-year lease would be precluded from deducting bona fide rental payments paid during a 10-year sublease. *Id.* at 23. The *Mathews* court noted that anybody else entering into this sublease could have deducted the rental payments. Because the court saw no good reason for Congress to prohibit a deduction to the reversioner alone, the deduction was allowed. *Id.*

78. Perry v. United States, 520 F.2d 235 (4th Cir.), *cert. denied*, 423 U.S. 1052 (1976).

79. *Van Zandt*, 341 F.2d at 440.

80. *See* Perry v. United States, 520 F.2d 235, 237-39 (4th Cir.), *cert. denied*, 423 U.S. 1052 (1976); *Van Zandt*, 341 F.2d at 440. In *Perry*, the court distinguished the facts at bar from the facts in other cases where courts had allowed the rental deduction. The court noted that in the latter cases, the grantor retained no reversionary interests in the trust corpus. *Id.* at 239. In *Van Zandt*, the Fifth Circuit reversed the district court's conclusion that the reversionary interest retained by the grantor upon the termination of the trusts was irrelevant, and stressed that it was a factor that should be taken into account in determining the element of business purpose. *Id.* at 444. The Fifth Circuit stated, "[F]actors such as . . . reversion to the settlors . . . bear heavily on the element of the business purpose." *Id.*

81. *See Mathews*, 61 T.C. at 20. For example, if the reversionary interest is derived from the lease, it would become possessory upon expiration of the lease. If the lease terminated prior to the trust, the taxpayer would have an interest in the property while the trust was still in existence, and thus a deduction would be disallowed. *Id.*

82. 44 T.C. at 524. In *Oakes*, a physician and his wife constructed, on land which they jointly owned, a building to be used in the husband's medical profession. *Id.* at 525. The taxpayer then transferred title to the land and building to the Security National Bank of Portsmouth, as trustee of an irrevocable 11-year Clifford trust, for the benefit of his four minor children. *Id.* at 525-27. Two days later, the trustee leased the building back to the taxpayer for $1,500 per year. *Id.* at 525. Two years later, by deed, the taxpayer assigned his reversionary interest in the property to his wife. *Id.* at 528.

83. *Id.* at 531. In allowing the deduction, the court did not decide whether a reversionary interest constituted "equity." *Id.* The court merely acknowledged that the reversionary interest held by the taxpayer had been relinquished on April 28, 1959. *Id.* Because the rental deductions in dispute related to the years 1959, 1960, and 1961, the court held that Oakes did not hold any prohibited equity in the property at the time the returns were filed. *Id.*

in *Chace v. United States*,[84] the Fifth Circuit disallowed a rental deduction because a reversionary interest existed, even though the interest had been transferred to the taxpayer's wife.[85] The recent trend among the courts has been to interpret the "no equity" requirement in section 162(a)(3) as allowing reversionary interests in the grantor.[86]

Against this background, the Court of Appeals for the Second Circuit began its analysis of whether a taxpayer who gives property to his children in trust may lease back that property for use as a professional office and deduct the rental payments from his personal income under section 162(a)(3) of the Code.[87] Recognizing that it was not writing on a *tabula rasa*, the *Rosenfeld* court remarked that it must invoke its Solomonic powers to determine which of the divergent views reached among the circuits accorded with the law and was the clearest course to follow.[88] The court began its analysis by acknowledging its acceptance of the Tax Court's *Mathews* four-prong test.[89] The court went on, however, to limit its discussion to the first and third prongs of

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84. 303 F. Supp. at 513. For a discussion of the facts of *Chace*, see note 35 and accompanying text *supra*.

85. 303 F. Supp. at 516. The grantor's "equitable interest" was found in his right to renew the lease at the end of three-year periods. *Id.* The district court conducted a close analysis of the language of § 162(a)(3) and concluded that the type of "equity" in property referred to in § 162(a)(3) must be one taken from the lessor, or at least overlapping a purported ownership interest of the lessor. *Id.* at 516. Any ownership interests possessed by the grantor would not become possessory until after the expiration of the lease and thus could not overlap with any ownership interests of the lessor. *Id. Cf.* Hall v. United States, 208 F. Supp. 584, 588 (N.D.N.Y. 1962) (taxpayer held to have equity because no one other than the grantor could acquire a fee interest in the property).

86. *See Quinlivan*, 599 F.2d at 269; *Mathews*, 61 T.C. at 12; Duffy v. United States, 343 F. Supp. 4 (S.D. Ohio 1972).

87. 706 F.2d at 1277.

88. *Id.* at 1280. While this issue had been addressed by other circuits, it was one of first impression in the Second Circuit. The *Rosenfeld* court noted that the tendency among the courts had been to allow the deduction, with the Third, Seventh, Eighth, and Ninth Circuits finding in favor of the taxpayer. *Id.* (citing *Quinlivan*, 599 F.2d at 269; Brooke v. United States, 468 F.2d 1155 (9th Cir. 1972); *Brown*, 180 F.2d at 926; *Skemp*, 168 F.2d at 598). The court noted that only the Fourth and Fifth Circuits had adopted the Commissioner's view. *Id.* at 1280 & n.4 (citing *Perry*, 520 F.2d at 235; *Van Zandt*, 341 F.2d at 440). For a discussion of *Quinlivan*, see notes 39-40 and accompanying text *supra*. For a brief discussion of *Brooke*, see note 32 and accompanying text *supra*. For a discussion of *Brown*, see notes 37-38 and accompanying text *supra*. For a discussion of *Skemp*, see notes 43-44 and accompanying text *supra*. For a discussion of *Perry*, see notes 41-42 and accompanying text *supra*. For a discussion of *Van Zandt*, see notes 56-58 and accompanying text *supra*.

89. 706 F.2d at 1280-83. The court of appeals quoted language from the Tax Court:

> To receive the deduction, "1) [t]he grantor must not retain substantially the same control over the property that he had before he made the gift, 2) [t]he leaseback should normally be in writing and must require the payment of a reasonable rent, 3) [t]he leaseback . . . must have a bona fide business purpose, [and] 4) [t]he grantor must not possess a disqualifying 'equity' in the property within the meaning of § 162(a)(3)."

*Id.* (quoting May v. Commissioner, 76 T.C. 7, 13 (1981)).

this analysis.[90]

In analyzing the first prong, the majority relied upon the Tax Court's finding that the trustees were independent.[91] The *Rosenfeld* court concluded that the broad grants of power to the trustees, the concomitant dimunition of Rosenfeld's rights, and the actual independence of the trustees adequately satisfied the first element of the *Mathews* test.[92]

In the second phase of its analysis, the court reasoned that to require a valid business purpose for the entire transaction, and not merely the leaseback, would result in the denial of most rental deductions since few gifts could be imbued with a valid business purpose.[93] The position that both the gift of property to the trust and the leaseback must have a legitimate business purpose, said the court, ignores the congressional policy inherent in the Clifford provisions.[94] Although compliance with the requirements of a Clifford trust is not dispositive of whether rental payments may be deducted, the court stated that the close interaction between the Clifford provisions and

90. *Id.* at 1280. After setting forth the *Mathews* four-prong test, the Second Circuit observed that the second and fourth prongs of the analysis were not in contention before them. *Id.* at 1280. The Commissioner conceded satisfaction of the second prong, agreeing that the lease was properly executed and that the rent was reasonable. *Id.* The fourth prong, which prohibits the grantor from holding any equity in the property, was challenged by the Commissioner in the Tax Court. 43 T.C.M. (CCH) 1353, 1356 (1980). However, the Tax Court found that under the trust agreement, the taxpayer's three daughters were the sole equitable owners of the property, and because Dr. Rosenfeld's reversionary interest was not derived from the lessor, or under the lease, he did not possess a disqualifying equity. *Id.* at 1356. This issue was never raised on appeal. 706 F.2d at 1277.

91. 706 F.2d at 1280, 1281. The *Rosenfeld* court noted that because the Tax Court had found the trustees to be independent, and because the Commissioner had presented nothing to the contrary, there was no reason to reject the Tax Court's finding. *Id.* at 1281.

92. *Id.* The Second Circuit concluded that the case *sub judice* was distinguishable from the earlier circuit courts' decisions in which trustees were found not to be independent. *Id.* (citing *Quinlivan*, 599 F.2d at 273 n.4; *Perry*, 520 F.2d at 235; *Van Zandt*, 341 F.2d at 440; White v. Fitzpatrick, 193 F.2d 398, 402 n.2 (2d Cir. 1951)). In reaching its conclusion, the court relied on the authorization given to the trustees to sell or mortgage the property, Rosenfeld's obligation to pay rent, and the prohibition against Rosenfeld subletting or assigning his rights. *Id.*

93. 706 F.2d at 1281, 1282. The Second Circuit opined that to require a valid business purpose for the entire transaction would be to impose too harsh a requirement. *Id.* Such a requirement would lead inevitably to a denial of the rent deduction, despite its clear business purpose, because the gift of the land was not *ipso facto* a business transaction. *Id.* The court also addressed the fact that many financial transactions are motivated primarily by legitimate tax savings rather than valid business concerns and agreed with Judge Learned Hand's view that a transaction does not become unlawful merely because an individual seeks to minimize the tax consequences of his activities. *Id.* (citing Gilbert v. Commissioner, 248 F.2d 399, 411 (2d Cir. 1957) (Hand, J., dissenting)).

94. *Id.* at 1281-82. In rejecting the strict requirement that both the gift and the leaseback have a valid business purpose, the court stated, "Quite simply, Clifford trusts are income shifting devices designed to shelter income, and we cannot lightly overlook the legislative determination that trusts which comply with §§ 671-678 are legitimate." *Id.*

section 162(a)(3) indirectly provides certain standards to be met for the creation of the trust as well as the leaseback.[95] Recognizing that Clifford trusts are "income-shifting devices designed to shelter income," the court implied that trusts which comply with the Clifford provisions carry a presumption of validity.[96]

The court thus rejected an approach that would focus on the business purpose of the transaction and instead adopted a standard which focuses on whether there has been a "change in the economic interests of the relevant parties."[97] The *Rosenfeld* court went on to examine the facts to determine the existence or extent of a change in the economic and beneficial rights of the taxpayer. The large amount of control given to the trustee, coupled with the independence of the trustee, allowed the court to conclude that Rosenfeld had changed his beneficial interest in the property by divesting both legal title and control.[98] The obligation to pay rent set forth in the lease agreement changed Rosenfeld's economic interests in the property.[99] The *Rosenfeld* court thus concluded that the rental deduction was properly allowed pursuant to section 162(a)(3) of the Code.[100]

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95. *Id.* at 1281. The *Rosenfeld* court went on to state, "Accepting the Commissioner's view, . . . 'would produce a benefit only in cases where investment property—not used in the grantor's trade or business—is placed in trust. Persons whose assets consist largely of business property would be excluded from a tax benefit clearly provided by Congress.' " *Id.* at 1282 (quoting *Quinlivan*, 599 F.2d at 274). For a further discussion of the interaction of § 162(a) and the Clifford provisions, see Shurtz & Harmelink, *supra* note 42, at 11-14.

96. 706 F.2d at 1281. The court also noted that it would be "difficult to imagine a case in which the establishment of such a trust could be viewed as furthering a taxpayer's business objectives." *Id.*

97. *Id.* at 1282. The court based its decision on the belief that if the legal rights and beneficial interests of the parties have changed, "there is no basis for labeling a transaction a 'sham' and ignoring it for tax purposes." *Id.* (citing United States v. Ingredient Technology Corp., 698 F.2d 88 (2d Cir. 1983); Gilbert v. Commissioner, 248 F.2d 399, 412 (2d Cir. 1957) (Hand, J., dissenting)).

98. *Id.* at 1282-83. The divestiture of legal title was premised upon the fact that in the execution of the trust Rosenfeld passed legal title to the trustees. Because the trustees were required to collect a fixed amount of rent, the majority concluded there was no reason to believe that this legal transfer was anything but an arms-length transaction. *Id.* at 1282.

99. *Id.* at 1280-81. The majority also noted that the trustees were authorized to sell or mortgage the property, grant easements, and exercise other ownership powers. *Id.* In holding that Rosenfeld's economic position had changed, the court noted that although the initial lease was co-terminous with the entire term of the trust, the amended lease was only for a single year, renewable for one additional year. *Id.* The Commissioner had argued that Rosenfeld's position had not changed because he was occupying the same premises as lessee which he previously had used as owner. *Id.* However, the Commissioner had conceded that a rent deduction would have been appropriate if Rosenfeld had given the property to his children and then rented other premises from a third party for his medical offices. *Id.* Because in both cases Rosenfeld would have voluntarily relinquished his right to occupy his offices rent-free and created the need to lease other premises, the Second Circuit could see no reason to distinguish the trust transaction from the hypothetical transaction. *Id.*

100. *Id.* at 1283.

Judge MacMahon filed a lengthy dissent which was premised on the belief that consideration of the economic reality, not the form of a financial transaction, was fundamental in determining tax liability.[101] First, the dissent criticized the majority's analysis under the business purpose test. Finding that it was illogical to require a business purpose for a gift, Judge MacMahon nonetheless rejected what he believed was the majority's contention—that a business purpose was required only for the leaseback.[102] Rather, the dissent believed that the contemporaneous gift and leaseback should be viewed as a single transaction.[103] In applying the business purpose test to the facts in *Rosenfeld*, Judge MacMahon concluded that the deduction must be disallowed.[104] When the gift and leaseback are viewed as a single transaction, Judge MacMahon believed that the test to be applied was whether a hard-headed businessman would have entered into the transaction. Judge MacMahon concluded that the under facts of *Rosenfeld*, the transaction failed this test.[105] In discussing the business purpose test, Judge

101. *Id.* at 1283 (MacMahon, J., dissenting). Judge MacMahon agreed with a dissent by Judge Learned Hand:

> The Income Tax Act imposes liabilities upon taxpayers based upon their financial transactions, and it is of course true that the payment of tax itself is a financial transaction. *If, however, the taxpayer enters into a transaction that does not appreciably affect his beneficial interest, except to reduce his tax, the law will disregard it*; for we cannot suppose that it was part of the purpose of the act to provide an escape from the liabilities that it sought to impose.

*Id.* (quoting Gilbert v. Commissioner, 248 F.2d 399, 411 (2d Cir. 1957) (Hand, J., dissenting) (emphasis supplied by the court)).

102. *Id.* Remarking that the majority misunderstood the government's contention, Judge MacMahon stated that "[i]t is illogical to require a business purpose for a gift, and this is not the government's argument. The government argues that the contemporaneous gift and leaseback be viewed as one transaction and that the business purpose rule be applied to the taxpayer's claimed deduction for the 'business expense' of the resulting rental payments." *Id.* Therefore, he argued, the majority's characterization of the government's argument as requiring a business purpose for the gift, and a business purpose for the leaseback was incorrect. *Id.* at 1283-84 (MacMahon, J., dissenting).

103. *Id.* The dissent argued that the facts at bar and the relevant legal standards compelled a single transaction approach. *Id.* This argument was premised on the fact that the gift and leaseback were executed as one transaction. *Id.* Judge MacMahon stated as follows:

> "Gift and retained control must be regarded as inseparable parts of a single transaction, especially since it was only in their sum total that they had any reality in regard to the conduct of [taxpayer's] business. To isolate them . . . is to hide business reality behind paper pretense."

*Id.* at 1285 (MacMahon, J., dissenting) (quoting White v. Fitzpatrick, 193 F.2d 398, 400 (2d Cir. 1951)).

104. *Id.* at 1283 (MacMahon, J., dissenting).

105. *Id.* at 1287. (MacMahon, J., dissenting) The dissent argued that a hard-headed businessman would not sign a lease for an office he already owned and occupied. *Id.* A hard-headed businessman, he asserted, would not incur unnecessary expenses. *Id.* The dissent also reasoned that Dr. Rosenfeld remained liable on the mortgage so that the gift would not be subject to any mortgage liability, and thus, would be of greater value to his daughters. *Id.* No hard-headed businessman, argued the dissent, would have remained liable on the mortgage. *Id.*

The dissent also attacked the majority's finding that the $14,000 rental pay-

MacMahon also criticized the majority's rationale that consideration of "other factors" allowed the court to apply the business test only to the leaseback.[106] The other factor relied upon by the *Rosenfeld* court was the validity of the trust. The dissent remarked that legislative history indicated that this factor should be irrelevant in determining the validity of a section 162(a) deduction.[107] The dissent concluded that the taxpayer had begun paying rent to the trust in order to be certain that his purpose of a lifetime gift to his children would be fulfilled; that is, there was simply no business purpose to this transaction.[108] Moreover, the dissent argued that the four-prong test should never be utilized because a factual inquiry into the taxpayer's scheme years after its implementation made it more difficult for taxpayers to plan their affairs.[109]

Judge MacMahon also discussed Rosenfeld's retention of control over the property and argued that even if a bifurcated approach to the gift and leaseback were adopted, the deduction should still be denied because control was not relinquished by the execution of the trust.[110] Judge MacMahon stated that because the trustees, Rosenfeld's advisors, had planned the entire scheme without inquiring about other tenants while allowing Dr. Rosenfeld

ments were reasonable. Judge MacMahon argued that because the $14,000 figure was based upon the use of all three floors as office space, and because Rosenfeld had used one floor for storage, he had deducted a rental expense in excess of the amount required. *Id.* at 1284 (MacMahon, J., dissenting). Judge MacMahon asserted that the payment of rent in excess of that which is reasonable was based upon Rosenfeld's desire to increase the value of the gift to his daughters and lower the family's taxes. *Id.* Judge MacMahon stated, "The fact rent negotiations produced 'reasonable' results is totally irrelevant. Any bargaining is simply not at arm's length, because any rent exceeding expenses stays in the . . . family.' " *Id.* (quoting *Mathews*, 520 F.2d at 325). Because this rental amount was not reasonable, the dissent argued that the payments amounted to an assignment of $14,000 of the taxpayer's income to the trust. *Id.* This assignment, noted the dissent, would not be recognized under contemporary tax law standards. *Id.* (citing White v. Fitzpatrick, 193 F.2d 398 (2d Cir. 1951)).

106. *Id.* at 1285 (MacMahon, J., dissenting). The dissent noted that rather than using the validity of the Clifford trust to illustrate "one of these 'other factors,' " the majority used it as the only factor, and did not point to any other transaction for which a § 162(a) deduction is allowed without a business purpose. *Id.* The dissent criticized the majority for offering the validity of the trust as the sole other factor. *Id.* The dissent also criticized the majority's view that if the gift is a "sham," the deduction is denied, and if the gift is valid, the deduction is allowed, arguing that this reliance upon compliance with the Clifford trust section is incorrect. *Id.*

107. *Id.* at 1285-86 (MacMahon, J., dissenting). In rejecting the majority's rationale, Judge MacMahon relied on a Senate Finance Committee Report which, in the context of a discussion regarding Clifford trusts, stated, "*[T]his subpart also has no application in determining the right of a grantor to deductions for payments to a trust under a transfer and leaseback arrangement.*" *Id.* (citing S. REP. NO. 1622, 83d Cong., 2d Sess., *reprinted in* 1954 U.S. CODE CONG. & AD. NEWS 4621, 5006 (emphasis supplied by the dissent); *Perry*, 520 F.2d at 235).

108. *Id.* at 1287 (MacMahon, J., dissenting).

109. *Id.* The dissent then suggested that "[a] holding that rental payments arising from gift-leaseback transactions are not deductible simply would require taxpayers to find other, less hypocritical means of avoiding their taxes." *Id.*

110. *Id.*

to instruct them as to whether to make improvements, the transaction amounted to "passive acquiescence to the will of the donor."[111]

In analyzing the decision in *Rosenfeld*, it is submitted that the Second Circuit properly declined to adopt the position that compliance with the Clifford provisions of the Code requires a finding that the gift-leaseback transaction is valid. It is suggested that this finding is correct in light of the report of the Senate Finance Committee, which states that the Clifford provisions have no application in determining the right of a grantor to take deductions for payments to a trust under a transfer and leaseback arrangement.[112] After rejecting an approach which focused solely on the Clifford provisions, the *Rosenfeld* court turned to case law for guidance.[113] Following the lead of other circuit courts, the Second Circuit correctly invoked as its touchstone the test set forth by the Tax Court in *May* and *Mathews*.[114]

After adopting the control, writing, and equity prongs of the *Mathews* and *May* tests, the *Rosenfeld* court proceeded to reject the existing approaches to the business purpose prong.[115] In rejecting the existing approaches, the court adopted its own standard of review, requiring a taxpayer to substantially change his legal and beneficial interests.[116] However, it is submitted that although the *Rosenfeld* court may have attempted a compromise between the two extreme tests, in fact, it has set forth a standard of review that appears no more stringent than the bifurcated approach.[117] In doing so, the

111. *Id.* (quoting Commissioner v. Culbertson, 337 U.S. 733, 748 (1949)). The dissent also noted that the lease granted Dr. Rosenfeld the right to build additions to the building. *Id.* This, the dissent argued, is an indicia of ownership. *Id.* Also, the excessive rental payments made by Dr. Rosenfeld constituted a premium which the taxpayer was willing to pay because he was more than a co-tenant. *Id.* at 1286-87 (MacMahon, J., dissenting). The dissent also rejected the majority's argument that Dr. Rosenfeld transferred his reversionary interest to his wife, since the question is one of control and not one of equity. *Id.* Finally, the dissent discussed the fact that when the trust was amended, Dr. Rosenfeld's daughter was appointed trustee along with an attorney. *Id.* at 1288. (MacMahon, J., dissenting) The amendment provided that a majority vote was needed, but required that Barbara Rosenfield be among the majority. *Id.* Thus, the dissent concluded that the grantor's daughter was not only a trustee, but was also vested with veto power. *Id.* The dissent argued that Dr. Rosenfeld's discretion as to whether improvements should be made, the payment of all the expenses of the land except real estate taxes and structural repairs, the lack of competitors when the lease was executed, and the installation of his daughter as one of the trustees, were indicative of the fact that Rosenfeld's control over the building had not substantially changed after the gift was made. *Id.* Thus, concluded Judge MacMahon, Dr. Rosenfeld was " 'the actual enjoyer and owner of the property.' " *Id.* (quoting White v. Fitzpatrick, 193 F.2d 398, 402 (2d Cir. 1951)).

112. *See* S. REP. NO. 1622, 83d Cong., 2d Sess., *reprinted in* 1954 U.S. CODE CONG. & AD. NEWS 4621, 5006; 26 C.F.R. § 1.671-1(c) (1982).

113. 706 F.2d at 1280.

114. *Id.*

115. *Id.* at 1282.

116. *Id.* The court reasoned that "if the legal and beneficial interests of a taxpayer have changed, there is no basis for labeling a transaction a 'sham' and ignoring it for tax purposes." *Id.* (citing Gilbert v. Commissioner, 248 F.2d 399 (2d Cir. 1957) (Hand, J., dissenting)).

117. Under the bifurcated approach, a taxpayer must only imbue a valid busi-

Second Circuit has not only failed to suggest a more workable standard, but it has also added further ambiguity to an already confused area.[118] Although the language of the new test may suggest a compromise standard, the factors upon which the *Rosenfeld* court relied to determine whether its new standard had been satisfied should have already been considered in determining whether the grantor relinquished control. The Second Circuit looked to such factors as the broad grant of power to the trustees, Rosenfeld's legal obligation to pay rent, the independence of the trustees, and the dimunition of Rosenfeld's rights.[119] However, a review of earlier decisions, as well as the *Rosenfeld* decision itself, demonstrates that these factors should already have been considered under the control prong.[120] Thus, the new standard, although different in form, in substance is repetition of the analysis applicable in analyzing control.

Judge MacMahon, in dissent, correctly noted that the majority struggled to avoid application of the business purpose test by stating that other factors must be considered.[121] However, as the dissent noted, the only "other factor" relied upon by the majority was the validity of the trust.[122] Consequently, it is submitted that this new test adds no further inquiry into the position of the parties than does the test used to determine relinquishment of control.

It is further submitted that in the gift-leaseback transaction context, a test which requires a taxpayer to change his beneficial and legal position is, in reality, no test at all. By virtue of the fact that a taxpayer has transferred legal title of property to a Clifford trust, he will always change his legal position. Furthermore, because a taxpayer becomes obligated to pay rent as a result of the gift-leaseback transaction, his economic interests will have changed as well. Thus, the *Rosenfeld* court apparently has adopted a test in

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ness purpose for the leaseback transaction. Thus, where the taxpayer's business requires the use of office space, the taxpayer will prevail and the rental deduction will be allowed. Similarly, under the new test, a taxpayer will always prevail because gift-leaseback transactions, by definition, require a taxpayer to change his legal and beneficial interests. For a discussion of the bifurcated approach to the business purpose prong, see text accompanying notes 59-72 *supra*.

118. As a result of the new test adopted by the Second Circuit, a third standard has been added under which a court may determine whether a rental deduction should be allowed. In attempting to reach a compromise and alleviate the existing inconsistency among the courts, the *Rosenfeld* court has muddied the waters by adding a third test, which arguably goes no further than the bifurcated approach.

119. 706 F.2d at 1282.

120. *Id.* at 1281. For a discussion of earlier decisions which have considered these factors in analyzing control, see notes 32-47 *supra*.

121. 706 F.2d at 1285 (MacMahon, J., dissenting).

122. *Id.* The dissent also noted that this sole "other factor" relied upon by the majority should not be considered at all, because reliance on the validity of the trust does not withstand analysis. *Id.* The dissent correctly supported this argument by citing to the legislative history of the Clifford provisions which prohibits application of compliance with these provisions in determining the validity of rental deductions. *Id.* at 1285-86 (MacMahon, J., dissenting) (citing S. REP. NO. 1622, 83d Cong., 2d Sess., *reprinted in* U.S. CODE CONG. & AD. NEWS 4621, 5006).

which a taxpayer who has entered a gift-leaseback transaction will always prevail. In attempting to differentiate between a sham and economic reality, the *Rosenfeld* court has set forth a test which itself substantively lacks economic reality.

It is difficult to ascertain whether the *Rosenfeld* decision will provide the impetus for Congress to intervene and establish a uniform standard so that all taxpayers will be treated alike. However, the decision, which adds a third approach to an already confused area, makes it incumbent upon Congress to resolve the uncertainty especially in light of the Supreme Court's repeated refusal to consider the question.[123]

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123. The Supreme Court has consistently refused to grant certiorari on cases presenting this issue. *See, e.g.*, Quinlivan v. Commissioner, 599 F.2d 269 (8th Cir.), *cert. denied*, 444 U.S. 996 (1979); Van Zandt v. Commissioner, 341 F.2d 440 (5th Cir.), *cert. denied*, 382 U.S. 814 (1965); Brown v. Commissioner, 180 F.2d 926 (3d Cir.), *cert. denied*, 340 U.S. 814 (1950).